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Revisiting the rationale for a single national financial services regulator

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REVISITING THE RATIONALE FOR A SINGLE NATIONAL FINANCIAL SERVICES REGULATOR

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FSA Occasional Paper

Biographical Note

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1 Executive summary

1.1 Introduction

In an earlier paper (Briault, 1999) I put forward the case for a single national financial services regulator. Such a regulator, covering a broad range of financial services activities and spanning both prudential and conduct of business regulation, should be well placed to deliver effective, efficient and properly differentiated regulation in the current financial environment in the UK. That paper described the formation of the UK Financial Services Authority (FSA) and similar developments in other countries. It also discussed the factors which supported the creation of an integrated financial services regulator and commented on the relationship between a single regulator and a central bank.

So why revisit this case now? The purpose of this paper[1] is not simply to repeat the arguments set out in the earlier paper, but to review developments over the last three and a half years in the UK in an attempt to measure the performance of the FSA against the rationale for creating it in the first place. The FSA has gained some useful experience over this period from which to begin to draw some tentative conclusions about the success or otherwise of a single financial services regulator in the UK, even if these conclusions must be subject to qualifications at this stage. And although the FSA has been acting in most respects as a single regulator for the last three and a half years (see Briault, 1999, page 7), it only came fully into existence at midnight on 30 November 2001, when the Financial Services and Markets Act 2000 (FSMA) came into force. The 'alphabet soup' of the previous regulatory bodies, as Michael Taylor once described them (Taylor, 1995, page 7), has finally disappeared.

1 An earlier version of this paper was presented at an LSE Financial Markets Group Conference on the Institutional Organisation of Banking Supervision, on 7 December 2001. I am grateful to participants at that conference and to many colleagues at the FSA for their comments on this paper. Any remaining errors are, however, my own.

1.2 Structure

It is too early to draw firm conclusions, but the initial indications remain encouraging. To examine these, this paper:

- revisits the case for a single financial services regulator (section 2);
- provides an updated description of the UK institutional arrangements for financial regulation and for maintaining financial stability (section 3);
- focuses on the economies of scale and scope available to an integrated regulator (sections 4 and 5);
- explains how the FSA has developed a risk-based and cross-sector approach to regulation (section 6); and
- discusses the respective contributions of a central bank and an integrated financial services regulator to financial stability (section 7).

In the early days of the FSA, the emphasis tended to be primarily on the advantages of taking an integrated approach to the regulation of individual conglomerates. However, the experience over the last few years has demonstrated, in addition, the advantages of taking a cross-sector and integrated approach to market and industry-wide issues. This has yielded considerable benefits in terms of consistency, efficiency and effectiveness. And it has enhanced considerably the contribution made by the FSA – and through co-operation with the Bank of England and the Treasury – to wider financial stability issues.

2 The case for a single national financial services regulator

The rationale for an integrated national financial services regulator in the UK continues to reflect four primary considerations:

- market developments such as the increase in the number of financial conglomerates and the blurring of the boundaries between financial products make sector-based regulation increasingly less viable;

- there are economies of scale and scope available to an integrated regulator, and there is value in being able to allocate scarce regulatory resources efficiently and effectively;

- there are benefits in setting a single regulator clear and consistent objectives and responsibilities, and in resolving any trade-offs among these within a single agency; and

- there are advantages in making a single regulator clearly accountable for its performance against its statutory objectives, for the regulatory regime, for the costs of regulation and for regulatory failures.

The trends identified in my earlier paper towards an increase in the number of financial conglomerates, and a blurring of the boundaries between products, have continued. There have been further cross-sector mergers and acquisitions, both in the UK and elsewhere, and both domestically and cross-border. Financial services firms have also continued to expand through internal growth into new areas (in particular banks, insurance companies and fund managers have extended the range of the services and products they offer). And new entrants to the financial services sector continue to widen the range of the financial services they offer to their customers (in particular, some of the new entrants that began by offering an internet-based deposit-taking service have since moved into investment business by offering their customers access to a range of managed funds).

The UK has not been alone in this. The draft legislation to create an integrated financial services regulator in Germany states that:

> 'National regulatory structures need to reflect the realities of the financial services sector, which has become more dynamic and more complex over the past few years. Developments on the financial market are associated with increased risks to their stability, which can best be countered in the future not only through improved collaboration between the regulatory authorities, but through integrated regulation ... .
>
> Banks, insurance companies and securities firms are now competing in the same market for the same customers, with similar and often even identical products, and via the same distribution channels. The number of interfaces between the products of banks, investment companies, securities firms and insurance

> companies and their distribution is growing. The organisation and management of the individual financial institutions nowadays have comparable structures.
>
> The functions of banking and insurance services also overlap and supplement one another in their core financial dimensions such as savings, financial procurement and risk protections. The convergence of banking, insurance and securities products is particularly far advanced in relation to the granting of mortgage loans, in derivatives trading, in asset management and in the combination of investment funds for capital formation... .
>
> A similar convergence effect may be seen amongst product vendors and the distribution channels for all financial products, so that organisationally separate regulation can no longer cope. Insurance companies use the distribution channels of banks and vice versa. The new communication technologies, such as the Internet, make it easier than ever before for firms to break up the financial services added value chains and either to purchase all their products and services or parts thereof from others or else to offer their own products and services to third parties. The use of the new communication technologies subjects banks and insurance companies to the same strategic and operational risks, which calls for similar risk management for both sectors ... .
>
> Convergence between sectors within the banking and insurance industries and the securities firm is growing in any case. As the markets change, there is a need for action on a regulatory level, with a view to securing the future stability of the financial system. When markets change and reconstitute on a cross-sector basis, government regulation of such markets needs to be reorganised. Universal financial regulation is the best way of reacting to the dynamics of the changes in the financial market.' (German Federal Government, 2001, General provisions).

Such considerations, and the manner in which regulatory arrangements are being restructured in other countries, suggest that the balance of the argument is moving away from retaining or creating multiple financial services regulators differentiated by the types of firm they regulate, by the activities they regulate, or by the objectives of regulation.

My earlier paper noted the existence of single national financial services regulators in Denmark, Iceland, Japan, Korea, Norway and Sweden, in addition to the UK. Hungary joined this list in April 2000, Latvia in 2001, and Estonia in 2002. Austria, Germany and Ireland have announced their intentions to create single financial services regulators. The position remains under review in a number of other countries, including Finland, South Africa and Switzerland.[2]

However, this does not imply that there is any one model that is optimal for all countries in all circumstances, in part because financial markets have developed – and will continue to develop – differently in different countries. Moreover, there is no single blueprint even for single financial services regulators – countries that have adopted this model have developed different approaches to how their integrated regulator operates in practice. These differences include the responsibilities, powers and organisational structure of these regulators, and the legislation under which they operate (see Carmichael, 2001, for a discussion of these differences).

3 Institutional arrangements in the UK

The FSMA was passed by Parliament in the UK in June 2000, and came into force at midnight on 30 November 2001. It provides a single modern and flexible legislative framework covering almost the entire financial services sector. The main features of the legislation, and of its lengthy passage through Parliament, are described in Davies (2001b).

The new legislation provides the framework within which the FSA operates, including four high-level statutory objectives, the powers available to it, safeguards on the use of these powers, and a strong set of accountability mechanisms. An important feature of the new legislation is that, apart from setting out in broad terms the 'threshold conditions' that a firm must meet in order to be granted permission by the FSA to undertake one or more regulated financial activities in the UK, it does not set out any detailed rules and regulations for these firms. These are set by the FSA itself, in its Handbook of Rules and Guidance.

2 See also the survey of recent developments in industrial, emerging and transition economies in Sinclair (2000).

3.1 Statutory objectives

The four statutory objectives of the FSA are to:

- maintain confidence in the financial system;
- promote public understanding of the financial system, including the awareness of the benefits and risks associated with different kinds of investment or other financial dealing;
- secure the appropriate degree of protection for consumers, having regard to the differing degrees of risk involved in different kinds of investment or other transaction, the differing degrees of experience and expertise that different consumers may have in relation to different kinds of regulated activity, the needs that consumers may have for advice and accurate information, and the general principle that consumers should take responsibility for their decisions; and
- reduce the extent to which it is possible for a financial services firm to be used for a purpose connected with financial crime.

In an interim report as part of his review of competition and banking services in the UK, Don Cruickshank suggested that the FSA should be given a fifth statutory objective, 'to minimise the anti-competitive effects of requirements placed on authorised persons by the FSA' (Cruickshank, 1999, page 24). A competition objective was also proposed during parliamentary debate on the new legislation, but the outcome was to leave the four statutory objectives unchanged, whilst strengthening the emphasis on competition in the considerations set out in the FSMA to which the FSA must have regard in discharging its general functions.

In addition, the FSMA provides for strong external scrutiny of the FSA with regard to the impact of its regulatory activities on competition. The Director General of Fair Trading, the Competition Commission and the Treasury each have a role to play in reviewing the impact of the FSA's rules and practices on competition, particularly if a rule or a combination of rules is considered to have a significantly adverse effect on competition (Financial Services Authority, 2000b, page 6).

The FSMA includes two considerations relating to competition, namely the need to minimise the adverse effects on competition that may arise from anything done by the

FSA in the discharge of its general functions; and the desirability of facilitating competition between firms regulated by the FSA.

The other considerations set out in the FSMA to which the FSA must have regard in discharging its general functions are:

- the need for the FSA to use its resources in the most efficient and economic way;
- the responsibilities of those who manage the affairs of authorised persons;
- the principle that a burden or restriction imposed on a regulated firm should be proportionate to the benefits, in general terms, that are expected to result from the burden or restriction;
- the desirability of facilitating innovation in connection with regulated activities; and
- the international character of financial services and markets and the desirability of maintaining the competitive position of the UK.

The four statutory objectives and the seven considerations – or 'principles of good regulation' – have already provided a robust framework within which the FSA has developed both its Handbook of Rules and Guidance and its approach to risk-based regulation. Not all single financial services regulators have the advantage of modern, flexible and integrated legislation. Some integrated financial services regulators in other countries continue to operate under multiple sector-based pieces of legislation. But, in the UK, the single new legislative framework has proven to be a considerable benefit in terms of the impetus for integration; the setting out of a clear set of objectives and principles of good regulation; and providing a single set of powers over all regulated firms.

Meanwhile, the scope of the FSA has been widened further. In addition to the responsibilities of the nine regulatory bodies that the Chancellor of the Exchequer announced in May 1997 would be merged into a single regulatory authority (Briault, 1999, page 6), the FSA has also been given responsibility to be the UK Listing Authority; to regulate professional firms (solicitors, accountants and actuaries) that undertake a significant amount of regulated financial services activities; to regulate credit unions (from 2002); and to regulate mortgage advice and general insurance broking (expected to be from 2004).

3.2 Accountability and independence

The independence, powers and accountability of the FSA were refined as the new legislation progressed through Parliament. The FSA is independent of Government, but it can be called to account by Government and Parliament, and it must recognise the interests of all of its stakeholders. The FSMA establishes eight main accountability mechanisms for the FSA.

i) Parliament approves, and may amend, the legislation (both primary and secondary) under which the FSA operates. The broad framework of the FSA's objectives, powers and accountability set out in the new legislation has been subject to considerable Parliamentary scrutiny. Parliament debated the Financial Services and Markets Bill for over 200 hours and spent further time debating the secondary legislation thereafter. In addition, Parliament receives, and may debate, the FSA's Annual Report; Ministers are accountable to Parliament for the legislation under which the FSA operates; and the Treasury Committee of the House of Commons takes evidence from the FSA twice a year, as a matter of routine – once on its Plan and Budget for the coming year, and then on its Annual Report for the past year. The Committee may also at any time hold an inquiry on any subject of concern to it, take evidence in public from any witnesses it decides to summon, and publish a report. Reports by the Committee may then be debated in Parliament.

ii) The FSA's statutory objectives and the principles of good regulation describe the overall purpose of the regulatory system and the way in which Parliament expects the FSA to operate in practice. This provides the basis for political and legal accountability, since the FSA could be challenged in the courts on the grounds that it has failed to pursue its objectives or to take the principles into account.

iii) The FSMA establishes public reporting mechanisms. The FSA is required to submit an annual report to the government describing how it has met its statutory objectives and carried out its functions. The government can prescribe what is covered in this report. The government is, in turn, required to lay the FSA's report before Parliament, which may debate it. In addition, the FSA is required to hold an annual open meeting to discuss its Annual Report, and to publish a report of that meeting. (See Financial Services Authority, 2001e, for a report of the 2001 meeting.)

iv) The FSMA establishes clear governance structures for the FSA. The FSA Board, including the executive members, is appointed (and may be removed) by the government. The non-executive members form the majority of the Board (currently 11 out of 15). The legislation gives the non-executive members of the Board specific responsibilities, beyond those that they have under company law – including overseeing the efficient and economic use of the FSA's resources and setting the pay of the executive Board members. The Board must also have regard collectively to the principles of good corporate governance.

v) The FSMA establishes mechanisms for direct input by practitioners and consumers to the regulatory process. In particular, the FSA is required to establish and maintain a Practitioner Panel and a Consumer Panel to advise it from the perspectives of practitioners and consumers. The FSA Board appoints the members of each panel after consultation with trade associations, consumer organisations and an open advertising process. Both panels are free to conduct research to fulfil their terms of reference and are given funds by the FSA to do this. These panels in turn report publicly on their work and make regular reports to the FSA Board. The FSA is required to report publicly on its response to the recommendations and views of the panels: if the FSA disagrees with the views or proposals represented to it by either panel it must publish a statement of its reasons for disagreeing.

vi) The FSA is required to consult publicly on proposed rules and regulatory guidance before issuing them. This consultation must explain how the proposed rules and guidance will meet its four statutory objectives and will be consistent with the principles of good regulation, and must include a cost benefit analysis. The FSA must then provide feedback statements explaining how it intends to address the points made during consultation. Consistent with both these statutory obligations and its stated intention to be open and transparent, the FSA has published 120 consultation papers since October 1997, covering all aspects of FSA policy and the entire text of the FSA's Handbook of Rules and Guidance (which came into force in its final form at the same time as the FSMA and contains, in a single location, the entire set of regulatory requirements placed by the FSA on regulated firms and approved persons). These consultation papers – and other related published papers – contain, where appropriate, a cost benefit analysis of the proposed policy and a statement of why the proposed policy is consistent with the FSA's statutory objectives and the principles of good regulation as set out in the FSMA.

vii) The FSMA establishes mechanisms for an independent review of the FSA's rules and decisions. This takes three particular forms. First, as discussed above, the effect of the FSA's rules on competition is subject to review by the Director General of Fair Trading and the Competition Commission. If they were to conclude that the

FSA's rules were significantly anti-competitive, the government could direct the FSA to change the rules in question. Second, a completely independent Tribunal, established and run by the Lord Chancellor's Department, which runs the court services, considers afresh case-related decisions by the FSA if the affected party chooses to refer a contested decision to the Tribunal. For example, if the FSA refused to grant a firm authorisation to conduct regulated business or decided to impose a financial penalty on a firm or individual, and there was no agreement between the FSA and the firm or individual concerned, the Tribunal would hear the case afresh. Third, the FSA is required to establish arrangements for handling complaints against itself (see Financial Services Authority, 2001f). These include appointing an independent Complaints Commissioner, who can report publicly on her conclusions and can require the FSA to respond publicly to her reports. In cases where the Commissioner has criticised the FSA's actions, she can also recommend that the FSA pay compensation to those adversely affected.

viii) The government has the power to commission and publish value-for-money audits of the FSA and to commission independent inquiries into serious failure of the system of regulation. The government has asked the FSA to notify it in writing as soon as circumstances or issues arise which are judged by the FSA to be serious enough to be likely to prompt the government to consider launching a statutory inquiry at some point in the future (HM Treasury, 2001).

3.3 Co-operation with the Bank of England and the Treasury

The FSA continues to co-operate closely, and to exchange information, with the Bank of England and the Treasury, under the 1997 Memorandum of Understanding (Financial Services Authority, 1997, pages 34-39). This Memorandum establishes the framework for co-operation among the three institutions in the area of financial stability. It sets out the roles of each institution (see also Briault, 1999, page 10), and explains how they work together towards the common objective of financial stability.

Discussions between the three institutions centre on a Standing Committee that has been meeting roughly monthly since March 1998, and has covered a wide range of possible domestic and international threats to UK financial stability. These have included:

- the position of individual financial institutions;
- the position of individual countries;

- the prospects for the UK and world economies, for specific economic sectors, and for equity and other financial markets;
- structural developments in financial markets; and
- operational resilience and contingency planning in the financial services sector, such as preparations for year 2000 and work following the attack on the World Trade Centre on 11 September 2001.

The close co-operation between the FSA and the Bank of England is reinforced by the cross-membership of the Chairman of the FSA as a member of the Court of the Bank of England, and by the Deputy Governor (Financial Stability) of the Bank of England being a member of the FSA Board.

The Memorandum of Understanding has helped to ensure timely and efficient co-ordination and allocation of work between the three institutions. The arrangements have not yet been put to the test in a period of massive financial instability, or of the 'failure' of a firm (or firms) posing a significant systemic risk. However, experience to date on co-operation and information-sharing between the three institutions suggests that the arrangements will work effectively in a crisis. Moreover, the FSA should, as a single financial services regulator, be able to provide better and more rapid access to information about the overall position of a financial conglomerate that ran into difficulties than might have been available in the past from the multiple regulators responsible for the individual firms within, or activities of, the conglomerate.

Indeed, Howard Davies, speaking as both the Chairman of the FSA and a former Deputy Governor of the Bank of England, has explained that these new arrangements have created a much better flow of information around the system, and have given the authorities a better insight into important parts of the financial markets than they had before. Of course the Bank of England had a privileged position in the banking system when it was a banking supervisor. But it had no formal relationships with the then separate securities and insurance regulators. Under the new arrangements, the Bank of England's perspective through the information provided to it by the FSA gives it a broader view of financial market developments. And as risks are transferred around the financial system, particularly between banks and insurance companies, this broader perspective assumes particular significance (Davies, 2001a).

4 Economies of scale

In the UK, the FSA (or rather the large number of regulated firms who meet its costs) has benefited from the economies of scale arising from the move to a single set of central support services (information services, premises, human resources, financial control etc); a unified management structure; and a unified approach to standard-setting, authorisation, supervision, enforcement, consumer education and tackling financial crime. A single complaints handling regime and a single compensation scheme have also been established.

This unification has been reflected in the FSA costing less, in real terms, between 1998 and 2002 than the sum of the predecessor regulatory bodies that have been brought together. This is despite the wider scope of the FSA, beyond the responsibilities of these predecessor bodies, and despite the FSA's staff costs having to reflect (albeit not to the full extent) the markedly higher rate of earnings increases in the UK financial sector over the last few years than the increase in average earnings across the economy as a whole. The FSA's budget fell in real terms in each of the four years from 1998/99 to 2001/02 (Financial Services Authority, 2001a, page 45).

It is, however, difficult to provide a precise comparison of costs, because of the changes in the FSA's scope, the impact of transitional costs in moving to a single regulator, and the difficulties in allocating costs in earlier years to the regulatory functions of institutions with other responsibilities (in particular the costs of banking and insurance regulation when these were undertaken by the Bank of England and by the Department of Trade and Industry respectively). Moreover, the costs of the FSA will increase as a result of its additional responsibilities under the FSMA, and as it regulates credit unions, the providers of advice on mortgages and general insurance brokers.

5 Economies of scope

A single financial services regulator should be able to tackle cross-sector issues more efficiently and effectively than might be possible across a multiplicity of separate specialist regulators. This arises in three main areas, namely the setting of the standards for regulated firms, the supervision of individual firms, and the analysis of industry and market-wide issues.

5.1 Setting standards

The development of policy in the FSA – and in particular the construction of the FSA's single Handbook of Rules and Guidance – has been based in part on achieving an integrated approach, as reflected in the development of a single set of Principles for Businesses; a single set of Principles and a single Code of Practice for Approved Persons; a single statement of requirements for high-level systems and controls in regulated firms; and a single set of regulatory manuals setting out the FSA's approach to authorisation, supervision, enforcement and decision-making.

An integrated approach has also been adopted for the development of conduct of business and prudential requirements that are based more on the types of risk that may arise across a range of regulated activities (for example, the failure to disclose information to customers, or the impact of credit, market, insurance underwriting and operational risks) than on organising these requirements by types of firm.

However, this is not a 'one size fits all' approach, and appropriate differentiation has been achieved by taking into account the different degrees of protection required by different types of consumer and the different ways in which the FSA's requirements can be met according to the nature and size of a firm's business.

5.2 Supervising individual firms

Meanwhile, the supervision of each regulated firm brings together all of the regulatory requirements – prudential and conduct of business – to which each firm is subject. Since most firms are subject to both conduct of business and prudential requirements, and since compliance with these requirements depends to a large extent on firms' senior management and high-level systems and controls, there are considerable advantages in integrating prudential and conduct of business regulation in a single regulator.

The FSA has achieved a significant and valuable degree of integration through the establishment of a single division to supervise the 50 or so largest and most complex financial groups in the UK. The activities of these groups cover all aspects of financial services, and the teams responsible for these groups cover all aspects of the FSA's regulatory requirements. So, in most cases, a single team of supervisors monitors the adherence of a major financial conglomerate to all of the regulatory requirements applicable to the activities of that group, ranging from prudential to conduct of business, and from money laundering to the training and competence of the group's employees.

Similarly, although the other supervision divisions in the FSA are organised primarily by sector (banking, insurance and investment firms, and markets and exchanges), the same principle of integrated supervision applies – so for each firm a single team is responsible for monitoring all aspects of the business of the firm, covering both prudential and conduct of business regulation.

It is often suggested that there is a fundamental incompatibility between conduct of business and prudential regulation, or at least that they are best undertaken by separate regulatory agencies (see, for example, Taylor, 1995). The institutional structures of regulation in some countries reflect this, as for example in Australia and Canada.

However, experience at the FSA has demonstrated that in most cases there is no conflict between conduct of business and prudential regulation. Both seek to protect consumers. And, to a large extent, both seek to mitigate the problems arising from the asymmetry of information between consumers and the providers of financial services (see Llewellyn, 1999, for a discussion of the rationale for the regulation of financial services).

Conflicts can nevertheless arise. In some cases treating customers fairly and providing them with useful information can threaten the financial soundness of a firm. For example, compensating one set of a firm's customers for the losses caused by past mis-selling by the firm could potentially damage the overall financial soundness of the firm. Or the disclosure of adverse information about a firm could worsen its financial position if the disclosure caused some of its customers to move their business elsewhere. In each case a balance has to be struck between the interests of particular groups of consumers.

Such conflicts are extremely difficult to resolve, irrespective of the institutional structure of regulation. But a balance has to be struck in some way, and in practice the FSA has done this within an appropriate framework of objectives and accountability. Solutions are, of course, also reached between separate regulators, even where they are pursuing different aims and objectives. But this may involve inefficiencies, particularly if information does not flow properly between the different regulators. And the outcome may reflect the balance of power between different regulators at a particular point in time, rather than a rational and coherent consideration of the problem.

Indeed, one of the conclusions of the Baird Report (Baird, 2001) on the regulation of Equitable Life was that, even though the 'die was cast' by the time the regulation of Equitable Life passed to the FSA, in the early days of the FSA the lack of integration of prudential and of conduct of business supervision gave rise to significant problems of communication and co-operation, and to issues relevant to the supervision of Equitable Life being missed or not properly followed up.

5.3 Industry-wide issues

Finally, this cross-sector and integrated approach applies not only to the regulation of individual financial firms and conglomerates, but also to other regulatory functions that have cross-sector implications. In this context, the FSA has been able to adopt a consistent, coherent and clearly focussed approach across the financial services industry to cross-sector issues.

First, the FSA has assessed the actual and potential impact on regulated firms, across all sectors of the financial services industry, of turbulence in markets and in the international and domestic economy, including:

- the collapse of LTCM, and the position of hedge funds more generally;
- developments in South-East Asia, Japan, Argentina and Turkey;

- the weakness of telecom firms in many countries; and
- the consequences of the tragic events of 11 September 2001, which extended to equity and bond prices, to the prospects for the US and the world economy, to the robustness of the insurance and reinsurance sectors, and to the specific consequences for the aviation and tourism industries.

Second, the FSA has taken a cross-sector approach to infrastructure and contingency planning issues. This has included work with the Bank of England and the Treasury under the auspices of the Standing Committee (see section 3.3 above).

Third, the FSA has considered a wide range of cross-sector issues, including:

- the risks and opportunities to its statutory objectives arising from the development of e-commerce in the financial services industry (Financial Services Authority, 2001b);
- the impact of low inflation on the providers of financial services and on their customers (Harley and Davies, 2001);
- how best to encourage and to require regulated firms to treat their customers fairly after the point of sale (Financial Services Authority, 2001c);
- the most effective ways of utilising the FSA's resources to combat money laundering (Financial Services Authority, 2001d);
- how to maximise the effectiveness of the resources devoted by the FSA to consumer education and to enhancing the awareness of consumers of financial services (including, for example, the provision of comparative information to consumers on a range of financial products);
- the implications of an ageing population for the financial services industry and for the FSA's approach to regulation;
- how best the FSA can harness market forces to help it to achieve its statutory objectives (Foot, 2001);
- how risks are transferred (in both directions) between banks and insurance firms – where there are considerable advantages in being able to study developments from both ends of these transactions; and

- how to improve the regulation of insurance firms, taking into account the lessons to be learned from the regulation of other sectors of the financial services industry (Financial Services Authority, 2001g).

6 Risk-based regulation and resource allocation

Any regulatory authority has to consider how it will allocate its limited resources in order to achieve, as far as possible, its high-level objectives. So the FSA has to consider the risks posed by individual regulated firms and by industry-wide developments to the achievement of its four statutory objectives, and to determine its own risk appetite within this context (Financial Services Authority, 2000a and 2000c). This is at the core of any risk-based approach to regulation and to resource allocation. And, in doing so, the FSA must have regard to the principles of good regulation.

6.1 Interpreting the statutory objectives

Market confidence is fundamental to any successful financial system; only if it is maintained will participants and users be willing to trade in financial markets and use the services of financial institutions. Maintaining this confidence involves preserving both actual stability in the financial system and the reasonable expectation that it will remain stable. This can be achieved through preventing material damage to the soundness of the UK financial system caused by the conduct of, or collapse of, firms, markets or financial infrastructure; and through explaining to consumers and firms the basis on which confidence in the UK financial system is justified – this includes stating explicitly what the regulator can and cannot achieve.

The FSA aims to maintain a regime that delivers as low an incidence of failure of regulated firms and markets (especially failures that would have a material impact on public confidence and market soundness) as is consistent with the maintenance of competition and innovation in the markets. This in turn requires careful evaluation of the probability of any collapse, and its likely impact on the financial system.

Maintaining market confidence does not imply that the FSA should aim to prevent all collapses, or lapses in conduct, in the financial system. Given the nature of financial markets, which are inherently volatile, achieving a ‘zero failure’ regime is impossible and would in any case be undesirable. Any such regime would be excessively burdensome for regulated firms and would not accord with the statutory objectives and principles set out in the FSMA. It would be likely to damage the economy as a whole and would be uneconomic from a cost-benefit point of view; it would stifle innovation and competition; and it would be inconsistent with the respective responsibilities of firms’ management and of consumers for their own actions. Considerable dangers would arise if consumers or market participants believed that no firm would ever be allowed to collapse. This would reduce the incentive for individuals or firms to take due care in assessing the risk attaching to their financial decisions.

Turning next to the public awareness objective, many consumers do not understand the financial system, the products and services offered and how they relate to their financial needs. Such consumers may not secure suitable products at fair prices; they may misunderstand the terms on which products are offered or may not realise the costs, risks and benefits of different product offerings. The FSA is pursuing two main aims under this objective, namely to improve general financial literacy and to improve the information and advice available to consumers, both from regulated firms and from the FSA itself. General financial literacy can be improved through programmes to help individuals acquire the knowledge and skills they need to be better informed consumers of financial services. And the availability and quality of generic information and advice to consumers can be improved through the efforts of both the financial services industry and the FSA.

On the objective to protect consumers, it is important to recognise that the protection of consumers covers both prudential and conduct of business considerations. The principal risks that consumers may face in their financial affairs are:

- the prudential risk that a firm collapses, for example because of weak or incompetent management, or lack of capital;
- the bad faith risk from fraud, misrepresentation, deliberate mis-selling or failure to disclose relevant information on the part of firms selling or advising on financial products;

- the complexity/unsuitability risk that consumers contract for a financial product or service they do not understand or which is unsuitable for their needs and circumstances; and
- the performance risk that investments do not deliver hoped-for returns.

The FSA has a clear role to play in identifying and reducing prudential risk, bad faith risk and some aspects of complexity/unsuitability risk. But it does not have a responsibility to protect consumers from performance risk, which is inherent in investment markets, providing the firm recommending the product has explained to the consumer the risks involved and has not made excessive and unrealistic claims. However, under the public awareness objective the FSA aims to ensure that consumers have a better understanding of the risks and opportunities involved in investment markets, so that consumers are better able to assume responsibility for their own decisions. And the level of protection provided by the FSA's regulation is tailored to depend on the sophistication of the consumer. Professional counterparties need (and want) much less protection than retail consumers.

Finally, confidence in the financial system and consumer protection will be seriously undermined if the financial system and individual institutions are abused for criminal purposes. The FSA is therefore charged with reducing the extent to which it is possible for the firms it regulates to be used in connection with financial crime. This includes money laundering; fraud or dishonesty, including financial e-crime and fraudulent marketing of investments; and criminal market misconduct, including insider dealing. The FSMA gives the FSA new powers in this area.

These objective-based considerations translate into a risk-based approach to regulation and to resource allocation in three main ways.

6.2 Regulation of firms

The first is the regulation of individual firms. The FSA assesses the risks posed by firms under two broad headings. One is the probability of an adverse event occurring, while the other is the impact that such an event might have.

In considering the *probability* of a problem occurring, particular attention is paid to two types of risk. The first is business risk, which includes:

- a firm's strategy;
- its credit, market, insurance underwriting and operational risk;
- its financial soundness (capital, liquidity, and earnings); and
- the nature of a firm's customers and of its products and services.

The second is control risk, including:

- a firm's organisation;
- its internal systems and controls;
- its board and senior management;
- its business and compliance culture; and
- a firm's treatment of its customers (its marketing, selling and advice practices).

Impact is assessed in terms of the damage that a problem within a firm could cause to the FSA's statutory objectives. This depends on three main considerations. The first is the degree of systemic significance of the firm (for example, would a problem at the firm have a contagion effect on other firms, or on the industry as a whole?). The second is the perceived importance of the firm (including the possible impact on market confidence). And the third is the size and nature of the firm's customer base. The inclusion of these 'impact' factors, based on the FSA's four statutory objectives, means that the FSA does not look at risk in quite the same way as market participants.

A combination of these probability and impact factors determines the nature and intensity of the supervision of individual regulated firms by the FSA. This supervisory relationship is placed along a broad spectrum. At one end of the spectrum is an intensive and continuous close relationship with a high risk and high impact regulated firm, in order to develop and maintain a detailed and timely understanding of current and potential areas of risk in a firm. At the other end of the spectrum, the supervision of firms with a low impact grading relies primarily on the remote monitoring of a firm's business through information reported to the FSA, supplemented by the sampling of particular lines of business undertaken by particular types of firm, and by thematic work (as described in section 5.3 above).

So the allocation of the FSA's resources – across firms and across sectors – is determined by the result of the analysis of the risks posed by individual firms. And the need for such risk-based resource allocation is highlighted by the observation that the 1% of regulated firms in the highest impact category have a 64% share of the financial services markets in which they are active.

6.3 The wider environment

Experience of financial regulation suggests that it is also useful to take a broader perspective if a regulator is to be effective in identifying and heading off risks to its objectives. So the second major element in the risk-based approach is to look at industry-wide risks to the FSA's statutory objectives arising from developments in the economy and in products and markets. This is based on sources of information such as the supervision of individual regulated firms, close contact with consumers and practitioners, the availability of data on complaints against firms, economic data, and developments in the government's social policy.

At the broadest level the FSA considers the possible implications for the achievement of its statutory objectives of:

- developments in the macro-economy (for example, the implications of low inflation, the possible nature of the next recession, or the possibility of a stock market correction);
- demographic trends (in particular the ageing population); and
- the agenda set by related government policies (see, for example, Johnson, 2000, for a discussion of the interface between regulation and some aspects of government social policy).

The thematic work discussed in section 5.3 above is also relevant here, as is the work of the FSA in the international arena (see section 7 below).

As with the risks posed by individual firms, the main focus in prioritisation and resource allocation in this broad context is to assess the extent to which any of these industry-wide risks poses a threat to the FSA's statutory objectives. And as with individual firms, this is considered in terms of both probability and impact.

6.4 Appropriate regulatory response

The third major element of the risk-based approach is to assess which of the regulatory responses, if any, available to the FSA are the most appropriate – singly or in combination – to mitigate each of the risks posed to the statutory objectives either by individual firms or by industry-wide developments. These responses include:

- setting the standards that firms and approved persons are expected to meet;
- authorisation, to impose minimum standards at the point of entry;
- supervision, on the risk-based approach described above;
- disclosure of product information, of trades undertaken, and of the financial soundness of firms;
- consumer education;
- the investigation of possible breaches of rules;
- intervention to limit the activities of firms;
- discipline under the powers of the FSMA;
- co-operation with overseas regulators (in authorisation, supervision, enforcement and standard-setting);
- restitution for consumers where they have suffered losses because firms have breached rules;
- the Financial Ombudsman Scheme to deal with complaints that have not been resolved between a customer and a firm; and
- the Financial Services Compensation Scheme.

7 Regulation and central banking

Three broad conclusions on regulation and central banking were set out in my earlier paper.

The first was that many of the 'traditional' arguments against combining responsibilities for monetary policy and banking supervision in a single institution were difficult to sustain. For example, the argument that there could be conflicts of interest between banking supervision and monetary policy if undertaken within a single institution was rejected as having little or no substance in practice (Briault, 1999, page 28). Meanwhile there are arguments in favour of combining banking regulation and monetary policy responsibilities in the same institution (see, for example, Goodhart, 2000). So the real issue here is not simply whether there are advantages in combining banking regulation with monetary policy, but rather whether the synergies in doing so are greater or less than the alternative synergies arising from the creation of a single financial services regulator.

The second conclusion was that although there certainly need to be close links and a proper two-way flow of information between the monetary authorities and an integrated financial services regulator, this does not imply that the two functions need to be combined within the same institution (Briault, 1999, page 29). Experience in the UK since the creation of the FSA has demonstrated that information can and does flow effectively, in both directions, between a central bank and a separate integrated financial services regulator.

The importance of information exchange is stressed heavily in the Memorandum of Understanding (see section 3.3 above), and the Bank of England and the FSA are fulfilling the requirement to 'establish information sharing arrangements to ensure that all information which is or may be relevant to the discharge of their respective responsibilities will be shared fully and freely' (Financial Services Authority, 1997, page 37). In particular, the Bank and the FSA share and discuss at all levels a large volume of information and analysis on economic and financial developments and the implications of these for financial stability. And information on potential problems is shared rapidly between the Bank and the FSA, irrespective of who first becomes aware of the potential problem, thereby enabling both institutions to interpret relevant information at times of stress.

The third conclusion in my earlier paper was that although 'systemic risk' provides a rationale for regulatory intervention, if the failure of some financial institutions could impose negative externalities on others, this does not require the creation of a separate regulator with a specific 'systemic risk' mandate (Briault, 1999, pages 30-32). Indeed, the creation of such a regulator could increase the moral hazard problem, arising from the perception that some financial institutions are more likely than others to be protected and supported in the event of problems occurring.

Also, it is not clear what, in practice, a 'systemic risk' regulator would do differently from a 'deposit protection' regulator, or why. Where differences can be identified (for example, to take account of the potential externalities arising from the systemic impact of the failure of some regulated firms), they can be addressed by a single regulator through appropriate differentiation (as, for example, through the assessment and application of the 'impact' factor described in section 6.2 above in the context of risk-based regulation). And if the existence of multiple specialist regulators led to the emergence of inappropriately differentiated approaches then the market place could be seriously distorted.

Some commentators (for example, European Central Bank, 2001) have suggested that a single regulator would not be interested in systemic risk or financial stability. However, as explained in section 3.3 above, the UK system is based firmly on the respective roles of the FSA, the Bank of England and the Treasury working together collectively towards the common objective of financial stability. For the FSA, this follows in particular from its statutory objectives of maintaining market confidence and protecting consumers. In pursuing these statutory objectives, and its responsibilities set out in the Memorandum of Understanding, the FSA plays a major role in both the monitoring and the mitigation of systemic risk.

As set out in section 6.2 above, in its supervision of individual financial services firms the FSA undertakes an assessment of the impact that might result if a firm was to run into difficulties. This impact assessment includes the possible systemic consequences of such difficulties, both on other financial services firms and on the UK and other economies more generally. The intensity with which the FSA supervises financial services firms is then determined by a combination of this impact assessment and the risks that the firm poses to the FSA's objectives (including both market confidence and consumer protection).

In addition, as discussed in sections 5.3 and 6.3 above, the FSA's risk-based approach to regulation places considerable emphasis on industry-wide risks and developments, including UK and global economic developments, and demographic, sectoral and market developments (indeed, information and analysis from the Bank of England provides an important input on many of these factors). All of these developments will have consequences for the financial positions of individual financial services firms and for sectors of the financial services industry, and some will have implications for financial stability and systemic risk.

The FSA's approach to bringing together the micro and macro elements of regulation is therefore an effective and efficient means of meeting its statutory objectives. The distinction that is often drawn between 'micro-prudential supervision' and 'macro-prudential analysis' (see, for example, European Central Bank, 2001, page 3) is neither useful nor meaningful here, since in practice the FSA is heavily involved in both of these functions.

Also in the context of systemic risk, the market developments that have strengthened the case for single financial services regulators – such as the creation of financial conglomerates – could potentially lead to an increase in systemic risk. But it does not follow from this that central banks should undertake prudential regulation. The growth of financial conglomerates need not make any difference to the ability of a central bank without regulatory responsibilities to monitor systemic risk, and of both the single regulator and the central bank to contribute to financial stability, providing that there is a proper two-way flow of information between the regulator and the central bank. Indeed, as discussed in section 3.3 above, one advantage of an integrated regulator is that it can provide the authorities collectively with a better insight into complex financial institutions and into industry-wide developments than might be possible with multiple financial services regulators (see also Briault, 1999, page 33).

The European Central Bank has also argued that financial services regulators located outside a central bank will be hampered by having an 'exclusively domestic mandate' (European Central Bank, 2001, page 8), and by a lack of independence (European Central Bank, 2001, page 5).

On the first of these arguments, national central banks within the euro area are mandated to co-operate with each other as members of the European System of Central

Banks. Equally, however, national financial services regulators are mandated to co-operate and to share information with each other under various EU Directives.[3] Moreover, there is no empirical basis for the assertion that central banks, even those within the euro area, are more internationally-focused than non-central bank financial services regulators (whether integrated or not) and therefore better able to take account of the cross-border implications of difficulties arising in the financial system in a particular country.

The international activities and responsibilities of the FSA are evident from the large number of overseas financial services firms who are operating in the UK, from the international operations of UK financial services firms, and from the involvement of the FSA in international policy committees. The FSA plays a substantial role in bilateral and multilateral co-operation with financial services regulators (and other authorities, including non-supervisory central banks) throughout the world. This ranges from discussions with the numerous home state regulators of the overseas financial services firms operating in the UK, to the FSA's active participation in European and wider international regulatory committees and working groups (where the FSA is represented on more than 150 of these). International co-operation among financial services regulators is strong and has increased significantly in line with the growth in the cross-border activities of financial services firms. Indeed, it can be argued that the FSA is a considerably more effective contributor to this international co-operation than was ever possible when the regulatory responsibilities in the UK were split between multiple financial services regulators.

There may be some justification in the second argument in the context of some developing and transition countries, where the central bank stands (almost) alone as an institution with independence from political interference, with high status and reputation, and with the resources to recruit and retain high calibre staff (see, for example, Goodhart, 2000). In these circumstances the effectiveness of financial services regulation (at least of banks) could be compromised if this function was

3 For example, Article 28 of the Credit Institutions Directive (2000/12/EC) states that 'The competent authorities of the Members States concerned shall collaborate closely in order to supervise the activities of credit institutions operating, in particular by having established branches there, in one of more Member States other than that in which their head offices are situated. They shall supply one another with all information concerning the management and ownership of such credit institutions that is likely to facilitate their supervision and the examination of the conditions for their authorisation, and all information likely to facilitate the monitoring of such institutions, in particular with regard to liquidity, solvency, deposit guarantees, the limiting of large exposures, administrative and accounting procedures and internal control mechanisms.'

removed from the central bank. This could have a significant impact on the balance of considerations relevant to the creation of a single financial services regulator.

But this argument has little or no validity in most developed economies, where the independence of non-central bank financial services regulators can be achieved (as, for example, in the UK) through legislation that draws an appropriate balance between independence and accountability.[4] Indeed, much of the early comment on the FSA – in particular before the introduction into the FSMA of the full range of accountability mechanisms described in section 3.2 above – characterised the FSA as being too powerful and a law unto itself, rather than lacking in independence.

As noted in section 2 above, there is no universal model for the institutional structure of financial services regulation. And the debate on whether banking regulation should be located within or outside the central bank will no doubt continue in many countries for many years. But, at least in the UK, a structure has been put in place under which the synergies to be gained from an integrated financial services regulator have been developed alongside detailed arrangements for the effective two-way flow of information between the Bank of England and the FSA.

8 Conclusions

It is too early to reach firm conclusions about the success of the UK Financial Services Authority in delivering the benefits expected from a single national financial services regulator. The FSA is only three and a half years old, and the new legislation has only just come into force. However, a promising start has been made in responding to market developments; in achieving economies of scale and scope; in creating a unified approach to standard-setting, authorisation, supervision, enforcement and consumer education; in introducing risk-based regulation on a consistent basis across firms and markets; and in working collectively with the Bank of England and the Treasury to maintain financial stability.

4 The balance between independence and accountability is equally important for central banks. See, for example, Briault, Haldane, and King (1996).

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